



CENTER FOR SOCIAL AND ECONOMIC RESEARCH

Khreschatik Str. 10B, #410
252001 Kyiv
Ukraine

Tel. (38-044) 228-8660/ 228-1349
Fax (38-044) 228-8660/ 228-1349
E-mail: case@case.kiev.ua

UKRAINIAN DRAFT BUDGET 2001

**SOME BRIEF COMMENTS ON RECENT
BUDGET REVENUES REVISION**

Magdalena Tomczynska

e-mail: magdat@hiid.kiev.ua
magda@case.com.pl

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According to the Ministry of Finance report on preliminary data about state budget implementation in January to October an improvement in budget execution has been noticed. Budget surplus of Hr 1.12 billion has been achieved compared to a Hr 1.47 billion deficit in the same period of 1999. For the first 10 months of year 2000 actual budget revenues amounted to Hr 27. 68 billion and exceeded the projected target for the period by 4.7 percent. This constitutes 81.5 percent of the annual revenue projection and indicates an improvement compared to only 65.5 percent execution in the same period last year. Indeed, improvement in budget revenue generation was noted in October. The target for that month was met in 101.1 percent while in September actual revenues constituted only 79.9 percent of the projection.

In general, the following factors could explain overall better performance of budget revenues in 2000:

1. For the first time since gaining independence Ukraine achieves economic growth observed throughout the year. Real economic growth reached 5.1% in October. Due to, it is not surprising that actual budget revenue collection exceeds budget revenue projected on the assumption of 2% GDP growth this year. According to CASE experts' forecast year 2000 will end with 4.9 % GDP growth.
2. Economic growth accompanied by relative political stability has brought to better conditions for economic activity developments. As a result, improvements in both direct and indirect tax revenues could be expected.
3. Budget 2000 includes additional items, which were not incorporated into previous years' budgets. While considering its execution without the contribution of these additional items it appears that Hr 1.5 billion real decrease of budget revenues takes place in comparison with 9 months of last year.
4. Considerable increase in privatization receipts has been noticed. For the first 10 months privatization program resulted in almost Hr 1.3 billion, which is comparable with total privatization receipts collected during last 3 years.
5. The quality of budget revenues has improved as the share of non-cash receipts in budget revenues considerably declined. At the same time, an increase in the arrears to budget has been observed.

However, it should be underlined that the achievements do not represent higher tax compliance or lower tax avoidance. To large extent, these are the results of restriction enforcement. About 30 % of consolidated budget revenues were collected by force enforcement during last 8 months.

In mid-November, the government submitted to the Verhovna Rada revised draft budget for year 2001. According to the draft budget amended for second reading total inflows to the state budget are to amount to Hr 35.063 billion. Proposed revision exceeds draft state budget analyzed in the first reading by Hr 983 million. The revised consolidated budget remains balanced. Such sudden and considerable change in the level could be motivated by the necessity to, at least partially, balance the gap in budget revenues, which appeared after last reduction of privatization receipts (treated as budget revenues according to the Ukrainian methodology). In relation to the IMF pressure privatization receipts scheduled for next year have been reduced by almost Hr 3 billion and are expected to amount to Hr 5.9 billion. Although there are still serious doubts whether this figure can be achieved, the receipts look more realistically

than the previous estimates. However, as a consequence of such shift budget deficit emerged.

To obtain higher budget revenues the government has increased expected volume of tax inflows into 2001 budget. The government explains the increase of projected tax inflows by improvements in tax collection in August – October of current year and the adjustment of indicators for next year. In particular, enterprises' profits are expected to grow by Hr 1.5 billion, which will allow improving profit tax receipts by Hr 333 million. Besides, it is planned that increased income tax, excise and import tax collections will contribute (respectively by Hr 117 million, Hr 425 million, and Hr 43 million).

Above justification could appear to some extent rational and pragmatic in the light of budget statistics for October only (although developments behind statistical data undermine full credibility of this explanation – see points 1-5 above).

In addition, the justification becomes even less convincing while taking into account main macroeconomic indicators, which served for forecast of budget revenues next year. It especially refers to the assumptions in respect to the real GDP growth rate. It seems that 4 % real GDP growth assumed in the draft budget looks too optimistic. Due to expected deterioration of current favorable external factors (which substantially contribute to high GDP growth in 2000), GDP growth should be rather forecast at about 2.7 %. Thus, discrepancies in projected and eventual rate of GDP growth next year (and respectively in nominal GDP value) may be expected to negatively influence budget revenues collection abilities. It should be underlined that as a result of weak GDP forecast nominal budget revenues for next year appear to be overestimated.

Furthermore, doubts arise as real improvement in tax revenue flow this year is concerned. It seems that progress rather originates from better than expected overall economic developments than from improvements in tax collection. If this hypothesis is true, it poses a threat that expected increase in budget revenues will not be achieved in year 2001 unless considerable changes in both voluntary taxpayers compliance and tax administration efforts take place. Unfortunately, Ukrainian tax system reform has recently lost its momentum and the adoption of new Tax Code appears to be postponed.

The issue of fast implementation of tax system reform is also important from the perspective of capabilities to finance the necessary level of public spending in the most efficient and equitable way. Given serious fiscal situation major changes to the Ukrainian statutory tax system are required. With respect to overall progress in tax policy reform across the Baltics, Russia, and other countries of the former Soviet Union, Ukraine is considered a gradual reformer¹. It was classified to the group of countries (Armenia, Azerbaijan, Moldova, the Kyrgyz Republic, Tajikistan, Uzbekistan), which are somewhere in the middle of the process. For comparison, the Baltics very quickly adopted tax legislation that generally reflects internationally accepted market-oriented practices.

¹ L. Ebrill, O. Havrylyshyn, (1999), *Tax Reform in the Baltics, Russia, and Other Countries of the Former Soviet Union*, IMF Occasional Paper # 182

Table 1. Progress on Tax Policy

Country	Assessment of Degree of Policy Reform from 1992 Trough Mid-1998
Armenia	2
Azerbaijan	3
Belarus	4
Estonia	1
Georgia	2
Kazakhstan	2
Kyrgyz Republic	3
Latvia	1
Lithuania	1
Moldova	2
Russia	4
Tajikistan	3
Turkmenistan	5
Ukraine	3
Uzbekistan	4

Source: IMF Occasional Paper # 182

Note: Scale from 1 (high degree of appropriate market-oriented reform) to 5 (very little, if any, reform).

Draft budget for 2001 presented for a second reading in the Verhovna Rada foresees consolidated budget at about 27 % of GDP. From a macroeconomic perspective, of particular interest is a question whether the proposed overall revenue level is appropriate². This interest stem in part from the widely held belief that tax burden in Ukraine is too high. One of the alternative methods to evaluate the appropriate overall tax revenues level is to compare it to the average tax burden of a representative group of countries. Following table provides some statistical comparative information. It shows that Ukraine's level of tax burden is comparable with average level observed in other CIS countries.

Table 2. Comparative Levels of Tax Revenue, 1995-1997 (in percent of GDP)

	1995 - 1997
Ukraine	22.6
CIS unweighted average	24
Baltics unweighted average	36
OECD Europe	39.4
Developing Countries	18.2

Source: IMF Occasional Paper # 182, IMF Working Paper # 00/35, TACIS Ukrainian Economic Trends December 1999

² The literature on optimal tax theory provides little practical suggestion on the choice of the overall level of taxation. The reason is that much of theoretical frameworks has been developed to assess the optimal structure of taxes to raise a given tax burden. Thus, determining the optimal tax burden is conceptually equivalent to determining the optimal level of government expenditure (V. Tanzi, H. Zee, (2000), *Tax Policy for Emerging Markets: Developing Countries*, IMF Working Paper # 35)

Summing up, after the parliament approved the draft budget in the first reading, the government started to rework it, taking into account the criticism of the IMF and parliamentary deputies. The IMF considers the adoption of a realistic budget for 2001 as one of the main conditions for resuming the EFF program. However, serious doubts arise whether the reduction of privatization receipts for 2001 (as required by the IMF) compensated by parallel increase in budget revenues (in order to balance the budget) represents a step toward assurance a realistic budget for 2001.